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TAGS: PGOV PREL ECON EFIN IC
SUBJECT: TAX INCREASES AND FISCAL CUTS IN ICELAND'S 2010 BUDGET BILL

¶1. (U) Summary: The Minister of Finance announced next year's economic forecast and submitted the 2010 state budget bill to parliament October 1 when the parliament reconvened after its summer break. The forecast presented a bleak economic picture for the next two years and the budget was laden with significant tax increases and budget cuts. The budget proposal is traditionally the first bill to be submitted to parliament, and must pass before January 1 as the Icelandic fiscal year ends December 31. End summary.

Facts and Figures

¶2. (U) The Ministry of Finance recently announced the economic forecast for Iceland, which serves as a basis for the calculation of revenues and expenses in the 2010 state budget bill. The forecast presented a bleak picture for the Icelandic economy in the next two years. It noted that, despite a surplus of 88.6 billion ISK ($708 million USD) in 2007, the economic crisis created a deficit of 216.0 billion ISK ($1.73 billion USD), amounting to 42% of GDP in 2008. The deficit is predicted to decrease slightly to 182.3 billion ISK ($1.46 billion USD) in 2009 and drop to 87.4 billion ISK ($699 million USD) in 2010. State coffers are not expected to post positive gains until 2013, even with the assistance of stringent fiscal restraint.

¶3. (U) The forecast predicted purchasing power to fall by 10.4 percent in 2009 and by 11.4 percent in 2010; and for GDP to contract by 8.4 percent in 2009, a little less than previously expected, and by 1.9 percent in 2010. Unemployment for 2009 is expected to reach 8.6 percent and grow to 10.6 percent in 2010, a significant rise in a country where unemployment was about two percent before the financial collapse.

Tax Increases

¶4. (SBU) According to the 2010 budget bill, the government's goal is to reduce the deficit to 87.4 billion ISK ($699 million USD), or 6% of GDP, in 2010, in part by increasing revenues by 61.3 billion ISK ($490 million USD), primarily through tax increases. Significant income, fuel, alcohol and tobacco sales taxes are included among the proposed tax increases. One prospective new tax being debated is an energy, environmental, and resource tax, which could generate 16 billion ISK ($128 million USD) in revenue. Details on this proposed tax are scarce; however, the bill mentions the option of imposing a tax of one ISK per kWh of sold electricity. Aluminum companies are greatly displeased with this possibility. As the three aluminum smelters utilize 70 percent of all electricity in Iceland, this could result in a significant blow to those companies' profits. They are thus studying their long-term agreements with the government to determine whether or not they would be exempt from the tax. The spokesperson of one aluminum company, RioTintoAlcan, stated that such a tax would wipe out all of the company's profits

from its aluminum smelter in Straumsvik. Alcoa's managing director said this tax is directed towards companies creating jobs in Iceland and that he doubts such a step would help the country in attracting investors.

Budget Cuts

¶5. (U) To meet the goal of reducing the deficit to 87.4 billion ISK ($699 million USD) in 2010, the government also plans to implement 33.6 billion ISK ($269 million USD) in budget cuts next year. Among the proposed reductions are cuts for all ministries and the closure of three Icelandic embassies abroad. The reduction for the Ministry of Health, which operates the public health sector, will amount to 4 percent. Investment in transportation and infrastructure will fall by 33 percent. Allocations to the Icelandic Defense Agency (IDA) will be reduced by 21.5 percent in advance of its anticipated closure in 2010. Contributions to international development aid will be cut by 24.3 percent and the budget of the Icelandic International Development Agency will decrease by 16.1 percent. Salary reductions for state employees, ranging from three to 10 percent, are rumored to be imminent.

Comment

¶6. (SBU) Although the government is taking steps to turn the economy around, few expect to see any improvement until late 2010, at the earliest. Several cabinet members have confided to us that they expect this winter will be more difficult than last year. The full force of the economic crisis has not reached the general population, but will do so once the proposed cuts in benefits and services are implemented alongside significant tax hikes. At the same time, the government's bleak prognosis, which anticipates no economic growth until 2013, could also prove to be overly optimistic. For example, Iceland could fail to meet these targets due to several key variables, including how the Icesave dispute will be resolved, when the IMF loan will be disbursed and the success of the lifting of capital restrictions.

WATSON